TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 08-17

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

How the single article cap for the local option sales tax and the state single article sales tax apply to the sale and licensing of bundled software products.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

(A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
(B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
(G) The applicable law must not have been changed or amended;
(D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
(E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER], a Delaware corporation headquartered in [STATE-NOT TENNESSEE], is engaged in the business of licensing computer software to businesses throughout the United States. The Taxpayer also sells related software implementation services, optional software maintenance contracts, training classes, hosting and other services. All products and services sold by the Taxpayer are contracted for and invoiced separately from the sale of software.

The licensing of the Taxpayer's software is contracted under an end-user license agreement (the "License Agreement"). The Agreement grants the customer a perpetual license for the use of the software. The License Agreement contains provisions that restrict the customer's duplication and use of the software, and prohibit the customer from licensing, sublicensing or transferring the software to third parties, with the exception of affiliated entities. An appendix to the License Agreement is executed for each software sale, and within the appendix the software that is licensed by the customer is itemized in detail as to the specific software product.

There are two elements that factor into the determination of the price for the licensed software. The first element consists of the actual software product or products. The second element consists of the number of licenses granted for the product or products.

The software products are of two major types: core or basic software solutions and optional components. The pricing of the core or basic solutions is affected by the number and type of licensed users (professional, limited professional, employee, developer, etc.) These core solutions can be thought of as the Taxpayer's primary software applications that provide software solutions for general business processes. There are also numerous optional software components that tailor the core or basic solutions(s) to the needs of a specific industry. Both the core or basic software solutions and the optional components are software products that may be sold independently of each other.

Sales personnel strive to understand the customer's business needs and then point the customer to the Taxpayer's core applications and industry specific optional components that when purchased together will meet those needs. The customers have the ability to pick and choose what optional components they will purchase. The sales invoice for a software sale contains a single line that states that the invoice is for licensed software, without showing the names of the product(s) (*i.e.*, the core solutions or optional components) or the number of licensed users. Each software product is not listed individually on the sales invoice, but the appendix that has the details of the purchase is referenced on the invoice.

The price for all the software licensed, whether a core solution or optional component, is negotiated as a single sale. This price appears as a single amount in the appendix and on the invoice. However, the cost of each application or component is recorded in the company's billing records, reflecting the net value of the products after discounting from list prices and after negotiated credit(s) for previous purchases. This allocation of the single negotiated sales price is not provided to the customer, nor is it part of the appendix. It is instead part of the billing system, and results in all software products that were sold in a single negotiation being totaled and billed as one amount.

QUESTIONS

1. With regard to the facts presented herein, how is the single article cap for the local option sales tax applied to the licensing of the Taxpayer's software products?

2. With regard to the facts presented herein, how is the state single article sales tax applied to the licensing of the Taxpayer's software products?

RULINGS

1. The Taxpayer's software products are not subject to the single article cap for purposes of the local option sales tax, and the entire sales price will be subject to the local option sales tax.

2. The Taxpayer's software products are not subject to the single article cap for purposes of the state single article tax.

ANALYSIS

Under the Retailers' Sales Tax Act, Tenn. Code Ann. § 67-6-101 (2007) *et seq.*, the sale of tangible personal property is generally subject to the Tennessee sales and use tax. Tenn. Code Ann. § 67-6-702(a)(1) authorizes counties and incorporated cities to impose an additional tax on the first $1,600 of the sale of any single article of tangible personal property (the "local option sales tax"). Tenn. Code Ann. § 67-6-202(a) imposes an additional state tax at the rate of 2.75 percent on the amount over $1,600, but less than or equal to $3,200, on the sale or use of any single article of tangible personal property (the "state single article sales tax").

1. <u>The single article cap and the local option sales tax</u>

The Taxpayer's software products are not subject to the single article cap for purposes of the local option sales tax, and the entire sales price will be subject to the local option sales tax.

Tenn. Code Ann. § 67-6-702(a)(1) (2007) authorizes counties and incorporated cities to impose the local option sales tax on the first $1,600 of the sale of any single article of tangible personal property.[1] Tenn. Code Ann. § 67-6-702(d) defines the term "single article" for purposes of the local option sales tax as "that which is regarded by common understanding as a separate unit exclusive of any accessories, extra parts, etc., and that which is capable of being sold as an independent unit or as a common unit of measure, a regular billing or other obligation." Additionally, Tenn. Code Ann. § 67-6-702(d) provides that "[s]uch independent units sold in sets, lots, suites, etc., at a single price shall not be considered a single article."

The creation and transfer of computer software constitutes a taxable sale under Tennessee law, thereby subjecting the sale of software to the local option sales tax. Tenn. Code Ann. § 67-6-102(36)(B) (2007) defines the term "software" as tangible personal property for the purposes of the Tennessee sales and use tax. Specifically, that section states that:

> "Sale" also means such transfer of customized or packaged computer software, which is defined to mean information and directions loaded into a computer which dictate different functions to be performed by the computer, whether

[1] The $1,600 limit is referred to for purposes of this letter ruling as the "single article cap."

> contained on tapes, discs, cards, or other device or material. For such purpose, computer software shall be considered tangible personal property.[2]

Under the local option sales tax, a single article is taxed at the local rate only with respect to the first $1,600 of the sales price. However, if the item being sold does not meet the definition of a "single article," the entire sales price will be subject to taxation at the local rate. Therefore, it is necessary to determine under what circumstances packaged, prewritten or "canned" computer software products are "regarded by common understanding as a separate unit exclusive of any accessories, extra parts, etc., and that which is capable of being sold as an independent unit."[3] Tenn. Code Ann. § 67-6-702(d). A standard package software product developed for sale to the general public, *i.e.*, not customized or custom created software, is commonly understood as a separate unit, and the single article cap will apply to the sale of packaged software. Similarly, the Department also considers a license agreement that contemplates the transfer of rights to use certain standard packaged software products to be a single article for purposes of the local option sales tax and the state single article sales tax, provided that the agreement separately itemizes the consideration to be paid for each separate software package and license. *See Honeywell Information Systems v. King*, 640 S.W.2d 553 (Tenn. 1982) (taxpayer must treat sale of components as individual sales and not as packaged sale for each component to be considered a single article).

In *Honeywell Information Systems, Inc.*, 640 S.W.2d at 553, the taxpayer plaintiff leased computer components. The taxpayer's method of marketing, invoicing and record-keeping clearly demonstrated that it did not lease the component units of its computer systems as one single entity. Rather, it invoiced its customer for each of the components, each bearing its own serial number, and a specific monthly rental being charged for each component. The Tennessee Supreme Court held that since the taxpayer did not treat these components as "a single article of personal property" for purposes of its own leasing, invoicing and collections, the Commissioner for the Department of Revenue was likewise justified in treating them separately.

In *Executone of Memphis, Inc. V. Garner*, 650 S.W.2d 734 (Tenn. 1983), the Tennessee Supreme Court clarified that it is the character of each component, not how a taxpayer treats each component, that determines its status as a single article. The court dismissed the plaintiff's argument that the plugs, the switching systems, and the telephone units in a digital telephone

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[2] As of January 1, 2008, pursuant to Acts 2007 Public Chapter 602 the definition of "tangible personal property" will include "prewritten computer software."

[3] As of January 1, 2008, pursuant to Acts 2007 Public Chapter 602 "prewritten computer software" will be defined as: computer software, including prewritten upgrades, which is not designed and developed by the author or other creator to the specifications of a specific purchaser. The combining of two or more "prewritten computer software" programs or prewritten portions thereof does not cause the combination to be other than "prewritten computer software." "Prewritten computer software" includes software designed and developed by the author or other creator to the specifications of a specific purchaser when it is sold to a person other than the purchaser. Where a person modifies or enhances computer software of which the person is not the author or creator, the person shall be deemed to be the author or creator only of such person's modifications or enhancements. "Prewritten computer software" or a prewritten portion thereof that is modified or enhanced to any degree, where such modification or enhancement is designed and developed to the specifications of a specific purchaser, remains "prewritten computer software;" provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement of the price given to the purchaser for such modification or enhancement, such modification or enhancement shall not constitute "prewritten computer software."

switching system were components of a single article because no single component is sufficient on its own. The Court held that:

> In applying the considerations set out in Rule 6 to the present case, it requires no distortion to conclude that the plugs, the switching systems, and the telephone units, as they are described here, are "commonly understood" to be separate units. The Plaintiff admits that these articles have unit prices, that they can be put together to meet various office needs, and that if the occasion arose they could be sold separately to one who needs a system alteration. **To conclude that only the system itself constitutes a single unit completely ignores the separate physical character of each component part, both in the design of the system and in the ultimate benefit to the customer.**

Executone of Memphis, 650 S.W. 2d at 737 (emphasis added). Thus, it is character of each component, not how a taxpayer treats each component, that determines its status as a single article.

However, in *Colemill Enterprises, Inc. v. Huddleston*, 1996 Tenn. App. LEXIS 769 (Tenn.Ct.App. 1996), *rev'd on other grounds*, 967 S.W.2d 753 (Tenn. 1998), the Tennessee Court of Appeals held that the single article cap did not apply to a rebuilt airplane, because the plaintiff did not itemize the individual components and services separately on the invoice, with the result being that the Commissioner of Revenue had no means to determine the price of each individual component. The *Colemill* plaintiff rebuilt airplanes using numerous components, and claimed that the single article cap applied to the sale of the entire rebuilt airplane even though a portion of the sales price included charges for installation services (to which the single article cap does not apply). The Tennessee Court of Appeals rejected this argument, noting that the plaintiff charged one fee for an entire rebuilt airplane. Because the plaintiff did not itemize the individual components and services separately on the invoice, the Commissioner of Revenue had no means to determine the price of each individual component. The court agreed with the Commissioner that assessing tax on the full sales price was the only way the Commissioner could ensure that the full amount of the installation services were taxed, and that the aircraft parts were properly taxed as well. The single article cap therefore did not apply to the rebuilt airplane, and the entire sales price was subject to the local option sales tax.

Under the *Honeywell* and *Executone* analysis, the software solutions are properly characterized as single articles. However, under *Colemill*, the sale of these items for one lump-sum price causes the sale to no longer be subject to the single article cap. Furthermore, consistent with the *Colemill* analysis, Tenn. Code Ann. § 67-6-702(d) provides that "[s]uch independent units sold in sets, lots, suites, etc., at a single price shall not be considered a single article."

Unlike the plaintiff in *Honeywell Information Systems, Inc.*, the Taxpayer does in fact treat the sale of a software package as the sale of a single item. Rather, the Taxpayer treats the sale in the same manner as the plaintiff in *Colemill*. Specifically, the Taxpayer bundles the components together and negotiates a single sales price with a customer; the consideration paid to license each separate software package is not listed separately on the invoice or the appendix. The Taxpayer charges one non-itemized price for the sale of the core or basic software solutions and

the optional components. Although the Taxpayer keeps a list of the cost of each application or component in its billing records, it merely reflects the net value of each of the products after discounts and credits for a customer's previous purchases applied to the total sales price. As in *Colemill*, the Commissioner has no means to determine at what price the Taxpayer actually sells the core or basic software solutions and the optional components.

As illustrated in the *Colemill* decision and in Tenn. Code Ann. § 67-6-702(d), if a dealer does not allocate or determine a sales price corresponding to each single article, the single article cap will generally not apply, and the full sales price is subject to the local option sales tax. Because the Taxpayer's sale of the core or basic software solutions and the optional components cannot be broken down, the sale will not be treated as the sale of single articles. Accordingly, the single article cap will not apply, and the total sales price of the software packages will be subject to the local option sales tax. As such, the entire price of the sale is subject to local sales tax. Note that if the Taxpayer itemized the prices for the core or basic software solutions and the optional components on its customers' invoices, each component of the sale would be considered a single article.

In summary, the Taxpayer's software products are not subject to the single article cap for purposes of the local option sales tax, and the entire sales price will be subject to the local option sales tax.

2. The state single article sales tax

The Taxpayer's software products are not subject to the single article cap for purposes of the state single article tax.

Tenn. Code Ann. § 67-6-202(a) (2007) imposes an additional tax at the rate of 2.75 percent on the amount over $1,600, but less than or equal to $3,200, on the sale or use of any "single article" of personal property as defined in Tenn. Code Ann. § 67-6-702(d) (the "state single article sales tax"). For purposes of the state single article sales tax, the analysis set forth above applies because Tenn. Code Ann. § 67-6-202(a) uses the same definition of "single article" as the local option sales tax. As discussed above, the software products are not subject to the single article cap for purposes of the state single article tax under Tenn. Code Ann. § 67-6-202(a). Because the single article cap does not apply, the software would therefore not be subject to the additional state single article sales tax.

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APPROVED: Reagan Farr
Commissioner of Revenue

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